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2018 MID-YEAR SECURITIES ENFORCEMENT UPDATE

To Our Clients and Friends:

I. Significant Developments

A. Introduction

For a brief moment in time, after several years with as many as 3 of the 5 commissioner seats vacant, the SEC was operating at full force, with the January 2018 swearing in of newest commissioners Hester Peirce and Robert Jackson. This situation was short-lived, as Commissioner Piwowar, a Republican appointee with a deregulatory bent who had pulled back on certain enforcement powers, stepped down at the beginning of July. While the president has named a potential replacement, the Senate has not yet held confirmation hearings; with Democratic Commissioner Kara Stein also set to leave the agency sometime later this year, the Senate may defer consideration until both the Republican and Democratic nominees have been named. The vacancy could cause the Commission, which has already split on several key rulemakings, to defer some more controversial regulatory initiatives and even some enforcement actions which pose thornier policy questions.

Meanwhile, the most noteworthy Enforcement-related event came with the Supreme Court's *Lucia* decision, in which the Court held that the agency's administrative law judges have been unconstitutionally appointed, resolving a technical but significant legal issue which has dogged the SEC's administrative proceedings for several years. As discussed further below, the decision throws a wrench in the works for the Enforcement Division, which until the past couple years had been litigating a growing number of enforcement actions in its administrative forum rather than in federal court.

In terms of enforcement priorities, the SEC has continued to pursue a relatively small number of significant public company cases; despite a push in recent years to increase its focus on accounting fraud, few new actions were filed in the first half of 2018. In contrast, the Division filed a surprisingly large number of cases against investment advisers and investment companies, including advisers to individual retail clients, private fund managers, and mutual fund managers.

And the SEC's concentration on all things "cyber" continued to make headlines in the initial months of 2018. The SEC rolled out guidance on appropriate cybersecurity disclosures, and filed its first (and to date only) case against a public company for allegedly failing to report a data breach to investors on a timely basis. Additionally, the SEC continues to institute enforcement actions in the cryptocurrency space, though is focus remains primarily on outright frauds, leaving ongoing uncertainty as to the regulatory status of certain digital assets.

B. Significant Legal Developments

On June 21, 2018, the Supreme Court ruled in *Lucia v. SEC* that the SEC's administrative law judges (ALJs) were inferior officers of the United States for purposes of the Constitution's Appointments Clause, and that the SEC had failed to properly appoint its ALJs in a manner consistent with the Clause.[1] (Mr. Lucia was represented by Gibson Dunn before the Supreme Court.) After several years in which the SEC had increasingly filed contested proceedings administratively rather than in federal district court, the agency reversed course in the face of mounting court challenges to the constitutionality of its ALJs (who had been appointed by a government personnel office rather than by the commissioners themselves). Even with the reduced number of pending, litigated administrative proceedings, the SEC still faces the prospect of retrying dozens of cases which had been tried before improperly-appointed ALJs. As this report went to press, the SEC had yet to determine how it would handle these pending cases, or how or when it would go about appointing ALJs to hear litigated administrative proceedings going forward.

Even with *Lucia* resolving the primary legal question which had been floating about in recent years, other questions about the legality of ALJs may continue to complicate administrative proceedings, and thus for the time being the SEC has determined to pursue most litigated cases in court. (Though the SEC continues to bring settled administrative proceedings, as such settled orders are issued by the Commission itself rather than by an ALJ.)

Another Supreme Court decision that curtailed SEC enforcement actions, SEC v. Kokesh, continues to impact the enforcement program. As detailed previously, in June 2017 the Supreme Court overturned a lower court ruling that required the defendant to disgorge $34.9 million for conduct dating back to 1995. The Supreme Court found that disgorgement was a form of penalty and was therefore subject to a five-year statute of limitations.[2] In March 2018, on remand, the Tenth Circuit determined that the statute of limitations still did not bar the SEC's action since the "clock" restarted with each act of misappropriation.[3] Moreover, notwithstanding Kokesh, the issue of whether SEC actions seeking injunctive relief or other non-monetary sanctions (such as industry bars) are governed by the five-year statute remains hotly contested. In a May 2018 speech, Co-Enforcement Director Steven Peiken noted that the SEC continues to maintain that injunctive relief is not subject to the five-year statute of limitations under *Kokesh*, and admonished parties that the staff would not forgo pursuing actions based on such arguments.[4] However, the issue is far from settled, and just this month a district court came to a different conclusion.[5]

In June, the Supreme Court granted a petition of certiorari filed by Francis V. Lorenzo, an investment banker who copied and pasted his boss's allegedly fraudulent email into a message to his clients and who the D.C. Circuit found liable for fraud as a result[6]. Mr. Lorenzo has argued that, based on the Supreme Court's 2011 decision in *Janus Capital Group Inc. v. First Derivative Traders*, he should not be considered the "maker" of the allegedly fraudulent statements. Mr. Lorenzo's petition asserts that the D.C. Circuit decision allows the SEC to avoid the requirements of *Janus* by characterizing fraud claim as "fraudulent scheme" claims. A circuit split exists as to whether a misstatement alone can form the basis of a fraudulent scheme claim.

C. Whistleblower Developments

The first half of 2018 saw the SEC's largest whistleblower bounties to date, as well as some related rulemaking proposals which could potentially cap such awards. As of April, the SEC reported that it had paid more than $266 million to 55 whistleblowers since 2012.[7]

In March, the SEC announced its highest-ever whistleblower awards, paying a combined $50 million to two individuals and an additional $33 million to a third.[8] While the SEC may not disclose the identities of whistleblowers, their counsel subsequently publicly disclosed that the awards were paid in connection with a $415 million SEC settlement with a major financial institution alleged to have misused customer cash.[9] In its Order granting the awards, the Commission declined to grant awards to additional putative whistleblowers and, in doing so, clarified the standard for finding that a tip "led to" the success of a particular action.[10] For a tip to "significantly contribute[] to the success of an . . . action" and entitle the whistleblower to an award, the "information must have been 'meaningful,'" *i.e.*, must "'make a substantial and important contribution' to the success of the . . . action." The Commission declined to adopt a more flexible standard.

In a separate action the following month, the SEC awarded $2.2 million to a former company insider.[11] The SEC noted that the $2.2 million award was paid under the 120-day "safe harbor" rule, which provides that, when a whistleblower reports to another federal agency and then submits the same information to the SEC within 120 days, the SEC will treat the information as having been submitted on the day it was submitted to the other agency. A week later, the SEC announced a $2.1 million award to a former company insider whose tips had led to "multiple" successful enforcement actions.[12]

In addition to developments relating to award payments, the first half of 2018 also included a Supreme Court decision affecting the rights of whistleblowers pursuant to anti-retaliation protections. In *Digital Realty Trust*, the Court overturned the Ninth Circuit's decision (described in our 2017 Year-End Update) and found that Dodd-Frank's anti-retaliation measures protect only whistleblowers who report their concerns to the SEC and *not* those who only report internally.[13]

Finally, in a late June open meeting, the Commission voted to propose various amendments to its whistleblower program.[14] In response to the record-breaking award noted above, the proposed rules would give the SEC discretion to limit the size of awards in cases resulting in monetary sanctions greater than $100 million (which, given a permissible award size of 10-30% of money collected by the SEC, would effectively create a $30 million award cap). Other proposed amendments include:

- allowing awards based on deferred prosecution agreements and non-prosecution agreements entered into in criminal cases;
- permitting awards made when the Commission reaches a settlement outside the context of a judicial or administrative proceeding;
- allowing the SEC to bar individuals from later seeking awards after they submit false or frivolous claims;

- and, in response to *Digital Realty*, requiring a whistleblower to submit information in writing to receive retaliation protection.

D. Cybersecurity and Cryptocurrency

In 2017, the SEC touted cybersecurity as a major enforcement priority and created a dedicated "Cyber Unit" to investigate and prosecute cyber-related threats. The SEC's cyber-focus continued in the first half of 2018 with its February release of interpretive guidance on public companies' disclosure obligations regarding cybersecurity risks and incidents.[15] The Guidance, which reaffirms and expands upon the SEC Division of Corporation Finance's existing guidance on the topic from 2011, encourages companies to adopt "comprehensive policies and procedures related to cybersecurity," and to consider how their insider trading policies address trading related to cybersecurity incidents. While not creating any bright-line rules, it discusses that the "materiality of cybersecurity risks and incidents depends upon their nature, extent, and potential magnitude," as well as "the range of harm that such incidents could cause," including "harm to a company's reputation, financial performance, and customer and vendor relationships, as well as the possibility of litigation or regulatory investigations or actions." The SEC further noted that the existence of an ongoing internal or external investigation into an incident "would not on its own provide a basis for avoiding disclosures" of an otherwise material incident. As discussed further below, the Guidance was followed two months later by the SEC's announcement of its first enforcement action against a company arising out of a data breach.

Regarding the continuing proliferation of digital (or "crypto") currencies, the staff of the SEC's Divisions of Enforcement and Trading and Markets issued a statement in March reinforcing that digital platforms that trade securities and operate as an "exchange," as defined by the federal securities laws, must register as a national securities exchange or operate under an exemption from registration.[16] The statement also outlines a list of questions that potential investors should consider before deciding to trade on such platforms. The statement came on the heels of a litigated enforcement action charging a bitcoin-denominated platform, BitFunder, and its founder with operating an unregistered securities exchange, defrauding users by misappropriating their bitcoins and failing to disclose a cyberattack, and making false and misleading statements in connection with an unregistered offering of securities.[17] In a parallel criminal case, the U.S. Attorney's Office charged BitFunder's founder with perjury and obstruction of the SEC's investigation.

The SEC also brought a handful of initial coin offering (ICO) enforcement actions in the first half of 2018. In January, the SEC obtained a court order halting an ICO it characterized as "an outright scam," which had raised $600 million in just two months by claiming to be the world's first "decentralized bank" and falsely representing that it had purchased an FDIC-insured bank.[18] In April, the SEC charged two co-founders of a financial services start-up with orchestrating a fraudulent ICO by falsely claiming to offer a debit card backed by major credit card companies that would allow users to convert cryptocurrencies into U.S. dollars.[19] The U.S. Attorney's Office for the Southern District of New York brought parallel criminal actions against the co-founders, and the SEC later charged a third co-founder with fraud after discovery of text-messages revealing fraudulent intent.[20] Then, in May, the SEC obtained a court order halting an ICO by a self-proclaimed "blockchain evangelist" who had fabricated customer testimonials and misrepresented having business relationships with the Federal Reserve and dozens of companies.[21]

Additionally, in April, the SEC obtained a court order freezing over $27 million in proceeds raised by Longfin Corp. after the company and its CEO allegedly violated Section 5 by issuing unregistered shares to three other individuals so they could sell them to the public right after the company's stock had risen dramatically due to announcement of acquisition of a cryptocurrency platform.[22]

II. Issuer and Auditor Cases

A. Accounting Fraud and Other Misleading Disclosures

In March, the SEC settled charges of accounting fraud against a California-based energy storage and power delivery product manufacturer and three of its former officers.[23] The SEC alleged that the company prematurely recognized revenue to better meet analyst expectations, that a former sales executive inflated revenues by executing secret deals with customers and concealing them from finance and accounting personnel, and that the former CEO and former controller failed to adequately respond to red flags that should have alerted them to the misconduct. Without admitting or denying the allegations, the company agreed to pay penalties of $2.8 million; the former CEO and controller agreed to pay a combined total of approximately $100,000 in disgorgement, interest and penalties; and the former sales executive agreed to be barred from serving as an officer or director of a public company for five years and pay a $50,000 penalty.

In April, the SEC settled charges of accounting fraud against a Japanese electronics company.[24] The SEC alleged that the company's U.S. subsidiary prematurely recognized more than $82 million in revenue by backdating an agreement with an airline and providing misleading information to an auditor. The matter involved FCPA allegations as well.

Also in April, the SEC instituted settled proceedings against a California internet services and content provider.[25] The SEC alleged that the company failed to timely disclose a major data breach in which hackers stole personal data relating to hundreds of millions of user accounts. In addition, the SEC alleged that the company did not share its knowledge of the breach with its auditors or outside counsel, and failed to maintain adequate controls and procedures to assess its cyber-disclosure obligations. Without admitting the allegations, the company agreed to pay a $35 million penalty to settle the charges.

In May, the SEC filed a complaint against three former executives of a Houston-based health services company.[26] The complaint alleged that the executives falsified financial information—including financial statements for three fictitious subsidiaries acquired by the company—to induce a private firm to acquire a majority of the company's equity. In a parallel action, DOJ brought criminal charges against the defendants.

In June, the SEC filed a complaint against a California-based telecommunications equipment manufacturer and three of its executives.[27] According to the SEC's complaint, the executives inflated company revenues by prematurely recognizing revenue on sales and entering into undisclosed side agreements that relieved customers of payment obligations. The SEC also alleged that the defendants inflated the prices of products to hit revenue targets with the agreement that the company would later repay the difference as marketing development fees. Without admitting or denying the charges, the defendants agreed to pay penalties totaling $75,000. In addition, two of the individual defendants consented to five-year officer and director bars; the other individual defendant consented to a bar from appearing or practicing before the SEC as an accountant for five years.

B. Auditor Cases

In February, in a case the SEC said underscores its determination to pursue violations "regardless of the location of the violators," a foreign auditor and his U.S.-based accounting firm, settled charges alleging they providing substantial assistance in a fraudulent shell company scheme by issuing misleading audit reports for numerous companies.[28] The SEC suspended the auditor and his firm from appearing or practicing before the Commission.

In March, the SEC announced settled charges against several foreign firms of the large international accounting networks based on allegations that the firms improperly relied on component auditors that were not registered with the PCAOB, even though the component auditors performed substantial work that should have triggered registration.[29] The SEC alleged violations of PCAOB standards that require sufficient analysis and inquiry when relying on another auditor. Without admitting or denying the allegations, the four foreign firms agreed to pay roughly $400,000 combined in disgorgement and penalties.

Additionally, an auditing firm, two of its partners and a registered financial advisory firm settled charges in May relating to violations of the Custody Rule.[30] According to the SEC, the auditors failed to meet the independence requirements of the Custody Rule by both preparing and auditing financial statements of several funds and because they had a direct business relationship with the financial advisory firm through a fee-referral relationship. The SEC also charged the respondents for failing to comply with the requirement of regular PCAOB inspections and cited multiple professional conduct violations, including for failing to design and implement appropriate oversight mechanisms, insufficient quality control and violation of professional due care, among others. Without admitting or denying the allegations, the defendants were barred from appearing before the Commission and agreed to pay roughly $52,000 combined in disgorgement and penalties.

The SEC is also ensuring that firms are not associating with barred auditors. In April, an accounting firm and its sole officer and founder settled charges with the SEC for allegedly violating the Sarbanes Oxley Act of 2012, which prohibits auditors barred by the PCAOB from association with a registered public accounting firm from associating with corporate issuers in an accountancy or financial management capacity.[31] Without admitting or denying the findings, the company and its founding officer agreed to cease and desist from the association and agreed to pay a $22,500 civil penalty.

C. Private Company Cases

While the number of cases against public companies remains low, the SEC has continued to step up its enforcement efforts against private companies.

In March, the SEC instituted settled proceedings against a California-based financial technology company.[32] The SEC alleged that the respondent offered unregistered stock options to its employees without providing the employees with timely financial statements and risk disclosures. Without admitting the allegations, the company agreed to pay a $160,000 penalty to settle the charges.

Also in March, the SEC filed a complaint against a California-based health care technology company, its former CEO, and a former president at the company.[33] The complaint alleged that the defendants made numerous false statements in investor presentations, product demonstrations and media articles about their flagship product—including misrepresentations regarding expected revenue and the U.S. Department of Defense's adoption of the product—which deceived investors into believing the product was revolutionary. Without admitting the allegations, the company and former CEO agreed to settle the charges. Under the settlement terms, the former CEO agreed to pay a $0.5 million penalty, be barred from serving as an officer or director of a public company for ten years, return 18.9 million shares of the company, and relinquish her voting control by converting her Class B Common shares to Class A Common shares. The SEC will continue to litigate its claims against the former president in federal court.

And in April, the SEC filed a fraud complaint against four parties: a biotechnology startup formerly based in Massachusetts, its CEO, an employee, and the CEO's close friend.[34] According to the SEC, the CEO and the employee made false claims to investors about the company's finances and the company's progress in seeking FDA approval for one of its products. The complaint also alleged that the defendants engaged in a fraudulent scheme to acquire and merge the company with a publicly traded company, manipulated the shares of the new entity, and diverted a portion of the sale proceeds. The SEC is litigating the case in federal court and seeks to freeze the company's and CEO's assets, as well as prohibit the defendants from soliciting money from investors. In addition, the SEC seeks a permanent injunction, the return of the ill-gotten gains with penalties, and industry and penny stock bars. The DOJ brought parallel criminal charges against the individual defendants.

III. Investment Advisers and Funds

A. Fees and Expenses

In June, a private equity firm settled allegations that it had charged accelerated monitoring fees on portfolio company exits without adequate disclosure.[35] According to the SEC, the undisclosed receipt of accelerated fees from portfolio companies resulted in negligent violations of various provisions of the Advisers Act. To settle the matter, the Respondents agreed to pay $4.8 million in disgorgement and prejudgment interest and $1.5 million in penalties.

Shortly thereafter, the SEC filed a settled action against a New York-based venture capital fund adviser for allegedly failing to offset consulting fees against management fees in accordance with organizational documents for the funds it advised.[36] The SEC alleged that the adviser received $1.2 million in consulting fees from portfolio companies in which the funds had invested, and that those fees were not properly offset against advisory or management fees paid by investors, resulting in an overpayment of over $750,000. The adviser reimbursed its clients, plus interest, and agreed to pay a $200,000 penalty. Significantly, the SEC's press release cites to the adviser's remediation and cooperation, indicating that this was taken into account in determining the appropriate resolution.

B. Conflicts of Interest

In March, the SEC instituted settled proceedings against two investment adviser subsidiaries for undisclosed conflicts of interest with regard to the practice of recalling securities on loan.[37] The SEC alleged that the advisers were affiliated with insurance companies, but also served as investment advisers to insurance-dedicated mutual funds. The advisers would lend securities held by the mutual funds, and then recall those securities prior to their dividend record dates. This meant that the insurance company affiliates, as record shareholders of such shares, would receive a tax benefit on the basis of the dividends received. However, according to the SEC, this recall system resulted in the mutual funds (and their investors) losing income, while the insurance company affiliates reaped a tax benefit. Without admitting or denying the allegations, the advisers agreed to pay approximately $3.6 million to settle the charges.

In April, the SEC instituted proceedings against a New York-based investment adviser in connection with the receipt of revenue sharing compensation from a service provider without disclosing conflicts of interest to its private equity clients.[38] According to the SEC, the investment adviser entered into an agreement with a company that provided services to portfolio companies. Pursuant to that agreement, when portfolio companies made purchases, the service provider would receive revenue, and, in turn, the investment adviser would receive a portion of that revenue. Without admitting or denying the allegations of Advisers Act violations, the investment adviser agreed to pay nearly $800,000 in disgorgement, prejudgment interest, and civil penalties.

In early June, the SEC instituted settled proceedings against a New York-based investment adviser in connection with alleged failures to disclose conflicts of interest to clients and prospective clients relating to compensation paid to the firm's individual advisers and an overseas affiliate.[39] According to the SEC, this undisclosed compensation, which came from overseas third-party product and service providers recommended by the adviser, incentivized the adviser to recommend certain products and services and a pension transfer. The SEC also found that the adviser made misleading statements regarding investment options and tax treatment of investments. In settling the action without admitting or denying the allegations, the investment adviser agreed to pay an $8 million civil penalty and to engage an independent compliance consultant. In a parallel action, the Commission filed a complaint in federal court in Manhattan against the adviser's former CEO and a former manager.

On the same day, the SEC filed another settled administrative proceeding relating to undisclosed conflicts of interest with a Delaware-based investment adviser.[40] The settlement order alleges that the adviser negotiated side letters with outside asset managers resulting in arrangements under which the asset managers would make payments to the adviser based on the amount of client assets placed or maintained in funds advised by those asset managers. This was not disclosed to clients, and contravened the adviser's agreements with two specific advisory clients. The SEC also alleged that the adviser failed to implement policies and procedures to prevent conflicts of interest and failed to maintain accurate records relating to the payments from the outside asset managers. Without admitting or denying the Commission's findings, the adviser agreed to pay a $500,000 penalty.

C. Fraud and Other Misconduct

In January, the SEC filed settled charges against a California-based investment adviser and its CEO and President for failing to adequately disclose the risks associated with investing in their advisory business.[41] According to the SEC, the firm decided to borrow cash from investors—including its own retail investor clients whose portfolio accounts were managed by the CEO—in the form of promissory notes, in order to fund its business expenses, which exceeded the amount of money received from advisory fees. In their efforts to market the promissory notes, the CEO and President failed to disclose the true financial state of the firm or the significant risk of default. In settling the action, the investment adviser agreed to various undertakings, including an in-depth review and enhancement of compliance policies and procedures, and the provision of detailed information regarding noteholders to the staff. In addition, the firm paid a $50,000 penalty and each principal paid a $25,000 penalty.

Also in January, the SEC filed charges in the District of Massachusetts against two Boston-based investment advisers, alleging they engaged in various schemes to defraud their clients, including stealing client funds, failing to disclose conflicts of interest, and secretly using client funds to secure financing for their own investments.[42] The SEC also alleged that one of the individuals violated his fiduciary duties to clients by obtaining a loan from a client on unfavorable terms to that client and charging advisory fees over 50% higher than the promised rate. According to the complaint, the pair in one instance misappropriated nearly $450,000 from an elderly client, using the funds to make investments in their own names and to pay personal expenses for one of the individual advisers. The U.S. Attorney's Office for the District of Massachusetts also filed criminal charges against the same advisers in a parallel action. While the SEC action remains pending, the individuals have both pleaded guilty to criminal charges.[43]

The SEC also initiated a number of enforcement actions for alleged cherry-picking by investment advisers. In February, the SEC instituted a litigated action against a California-based investment adviser, its president and sole owner, and its former Chief Compliance Officer for allocating profitable trades to the investment adviser's account at the expense of its clients.[44] The SEC's complaint also alleges that the adviser and president misrepresented trading and allocation practices in Forms ADV filed with the Commission. The former CCO agreed to settle the charges against him—without admitting or denying allegations that he ignored red flags relating to the firm's allocation practices—and pay a fine of $15,000; the litigation against the investment adviser and president remains ongoing. And in March the SEC instituted settled proceedings against a Texas-based investment adviser and its sole principal for disproportionately allocating unprofitable trades to client accounts and profitable trades to their own accounts.[45] The investment adviser agreed to pay a total of over $700,000 in disgorgement, prejudgment interest, and civil penalties, and the principal agreed to a permanent bar from the securities industry.

In April, the SEC filed a settled administrative proceedings against an Illinois-based investment adviser and its president in connection with allegedly misleading advertisements about investment performance.[46] According to the SEC, the adviser did not disclose that performance results included in advertisements—in the form of written communications and weekly radio broadcasts and video webcasts by its president—were often based on back-tested historical results generated by the adviser's models, rather than actual results. The adviser also allegedly failed to adopt written policies and procedures designed to prevent violations of the Advisers Act. In reaching the agreed-upon resolution, the SEC took into account remediation efforts undertaken by the adviser during the course of the SEC's investigation, including hiring a new CCO and engaging an outside compliance consultant who conducted an in-depth review of the compliance program and made recommendations which were then implemented by the adviser. The investment adviser agreed to pay a $125,000 penalty, and the adviser's president agreed to pay a $75,000 penalty.

In May, the SEC charged a California-based individual investment adviser with lying to clients about investment performance and strategy, inflating asset values and unrealized profits in order to overpay himself in management fees and bonuses, and failing to have the private funds audited.[47] The adviser settled the charges without admitting or denying the allegations, agreeing pay penalties and disgorgement in amounts to be determined by the court.

Later that month, the SEC filed settled charges against a Delaware-based investment adviser and its managing member for allegedly making misrepresentations and omissions about the assets and performance of a hedge fund they managed.[48] According to the SEC, the adviser misrepresented the performance and value of assets in the hedge fund after losing nearly all of its investments after the fund's trading strategy led to substantial losses. In addition to making false representations to the fund's two investors, the adviser withdrew excessive advisory fees based on the inflated asset values. Without admitting or denying the charges, the adviser and managing member agreed to a cease-and-desist order under which the individual also agreed to a broker-dealer and investment company bar, as well as a $160,000 penalty.

In another pair of cases filed in May, the SEC charged a hedge fund and a private fund manager in separate cases involving inflated valuations. In one case, the SEC alleged that the fund manager's Chief Financial Officer failed to supervise portfolio managers who engaged in asset mismarking.[49] The asset mismarking scheme resulted in the hedge fund reaping approximately $3.15 million in excess fees. The SEC had previously charged the portfolio managers in connection with their misconduct in 2016. The CFO agreed to pay a $100,000 penalty and to be suspended from the securities industry for twelve months, while the firm agreed to pay over $9 million in disgorgement and penalties. In the other case, the SEC filed a litigated action in the U.S. District Court for the Southern District of New York against a New York-based investment adviser, the company's CEO and chief investment officer, a former partner and portfolio manager at the company, and a former trader, in connection with allegations that the defendants inflated the value of private funds they advised.[50] According to the complaint, the defendants fraudulently inflated the value of the company's holdings in mortgage-backed securities in order to attract and retain investors, as well as to hide poor fund performance. This litigation is ongoing.

Finally, in late June the SEC announced a settlement with an investment adviser that allegedly failed to protect against advisory representatives misappropriating or misusing client funds.[51] Without sufficient safeguards in place, one advisory representative was able to misappropriate or misuse $7 million from advisory clients' accounts. Without admitting or denying the SEC's findings, the adviser agreed to pay a $3.6 million penalty, in addition to a cease-and-desist order and a censure. The representative who allegedly misused the $7 million from client accounts faces criminal charges by the U.S. Attorney's Office for the Southern District of New York.

D. Investment Company Share Price Selection

The first half of 2018 saw the launch of the SEC's Share Class Selection Disclosure Initiative (SCSD Initiative), as well as several cases involving share class selections. Under the SCSD Initiative, announced in February, the SEC's Division of Enforcement agreed not to recommend financial penalties against mutual fund managers which self-report violations of the federal securities laws relating to mutual fund share class selection and promptly return money to victimized investors.[52] Where investment advisers fail to disclose conflicts of interest and do not self-report, the Division of Enforcement will recommend stronger sanctions in future actions.

In late February, a Minnesota-based broker-dealer and investment adviser settled charges in connection with the recommendation and sale of higher-fee mutual fund shares when less expensive share classes were available.[53] In turn, those recommendations resulted in greater revenue for the company and decreased customers' returns. The company, without admitting or denying the allegations, consented to a penalty of $230,000.

In April, three investment advisers agreed to settle charges in connection with their failure to disclose conflicts of interest and violations of their fiduciary duties by recommending higher-fee mutual fund share classes despite the availability of less expensive share classes.[54] Collectively, the companies agreed to pay nearly $15 million in disgorgement, prejudgment interest, and penalties. The SEC used the announcement of the cases to reiterate its ongoing SCSDC Initiative.

E. Other Compliance Issues

In January, the SEC announced settled charges against an Arizona-based investment adviser and its sole principal in connection with a number of Advisers Act violations, including misrepresentations in filed Forms ADV, misrepresentations and failure to produce documents to the Commission examination staff, and other compliance-related deficiencies.[55] According to the SEC, the adviser's Forms ADV for years misrepresented its principal's interest in private funds in which its advisory clients invested. While the clients were aware of the principal's involvement with the funds, the adviser falsely stated in filings that the principal had no outside financial industry activities and no interests in client transactions. Additionally, the SEC alleged that the adviser misstated its assets under management, failed to adopt written policies and procedures relating to advisory fees, and failed to conduct annual reviews of its policies and procedures. Without admitting or denying the SEC's allegations, the investment adviser agreed to pay a $100,000 penalty, and the principal agreed to a $50,000 penalty and to a prohibition from acting in a compliance capacity.

In April, the SEC filed settled charges against a Connecticut-based investment adviser and its sole owner for improper registration with the Commission and violations of the Commission's custody and recordkeeping rules.[56] According to the settled order, the adviser misrepresented the amount of its assets under management in order to satisfy the minimum requirements for SEC registration. The adviser also allegedly—while having custody over client assets—failed to provide quarterly statements to clients or to arrange for annual surprise verifications of assets by an independent accountant, as required by the Custody Rule, and also failed to make and keep certain books and records required by SEC rules. Without admitting or denying the allegations, the adviser and its owner agreed to the entry of a cease-and-desist order, and the owner agreed to pay a $20,000 civil penalty and to a 12-month securities industry suspension.

A few weeks later, a fund administrator settled cease-and-desist proceedings in connection with the company's alleged noncompliance in maintaining an affiliated cash fund.[57] According to the SEC, from mid-2008 to the end of 2012, the firm's pricing methodology for its affiliated unregistered money market fund was flawed. The SEC alleged that the deficiencies in the pricing methodology caused the affiliated cash fund to violate Investment Company Act. To settle the charges, the trust agreed to pay a civil monetary penalty of $225,000.

And in June, the SEC announced settlements with 13 private fund advisers in connection with their failures to file Form PF.[58] Advisers who manage $150 million or more of assets are obligated to file annual reports on Form PF that indicate the amount of assets under management and other metrics about the private funds that they advise. In turn, the SEC uses the data contained in Form PF in connection with quarterly reports, to monitor industry trends, and to evaluate systemic risks posed by private funds. Each of the 13 advisers failed to timely file Form PF over a number of years. Without admitting or denying the allegations, each of the 13 advisers agreed to pay a $75,000 civil penalty.

IV. Brokers and Financial Institutions

A. Supervisory Controls and Internal Systems Deficiencies

The SEC brought several cases during the first half of 2018 relating to failures of supervisory controls and internal systems. In March, the SEC filed a litigated administrative proceeding against a Los Angeles-based financial services firm for failing to supervise one of its employees who was involved in a long-running pump-and-dump scheme and who allegedly received undisclosed benefits for investing her customers in microcap stocks that were the subject of the scheme.[59] The employee agreed to settle fraud charges stemming from the scheme. The SEC alleged that the firm ignored multiple signs of the employee's fraud, including a customer email outlining her involvement in the scheme and multiple FINRA arbitrations and inquiries regarding her penny stock trading activity. The firm even conducted two investigations, deemed "flawed and insufficient" by the SEC, but failed to take action against the employee. The SEC previously charged the orchestrator of the pump-and-dump scheme, as well as 15 other individuals and several entities.

Also in March, the SEC announced settled charges against a New York-based broker-dealer for its failure to perform required gatekeeping functions in selling almost three million unregistered shares of stock on behalf of a China-based issuer and its affiliates.[60] The SEC alleged that the firm ignored red flags indicating that the sales could be part of an unlawful unregistered distribution.

At the end of June, the SEC charged a New York-based broker-dealer and two of its managers for failing to supervise three brokers, all three of whom were previously charged with fraud in September 2017.[61] According to the SEC, the firm lacked reasonable supervisory policies and procedures, as well as systems to implement them, and if those systems had been in place, the firm likely would have prevented and detected the brokers' wrongdoing. In separate orders, the SEC found that two supervisors ignored red flags indicating excessive trading and failed to supervise brokers with a view toward preventing and detecting their securities-laws violations.

B. AML Cases

During the first half of 2018, the SEC brought a number of cases in the anti-money laundering ("AML") arena. In March, the SEC brought settled charges against a New York-based brokerage firm for failure to file Suspicious Activity Reports (or "SARs") reporting numerous suspicious transactions.[62] The brokerage firm admitted to the charges, and agreed to retain a compliance expert and pay a $750,000 penalty. The SEC also brought charges against the brokerage firm's CEO for causing the violation, and its AML compliance officer for aiding and abetting the violation. Without admitting or denying the charges, the CEO and AML compliance officer respectively agreed to pay penalties of $40,000 and $25,000.

In May, the SEC instituted settled charges against two broker-dealers and an AML officer for failing to file SARs relating to the suspicious sales of billions of shares in penny stock.[63] Without admitting or denying the SEC's findings, the broker-dealers agreed to penalties; the AML officer agreed to a penalty and an industry and penny stock bar for a minimum of three years.

C. Regulatory Violations

In January, the SEC instituted a settled administrative proceeding against an international financial institution for repeated violations of Rule 204 of Regulation SHO, which requires timely delivery of shares to cover short sales.[64] The SEC's order alleged that the firm improperly claimed credit on purchases and double counted purchases, resulting in numerous, prolonged fail to deliver positions for short sales. Without admitting or denying the allegations, the firm agreed to pay a penalty of $1.25 million and entered into an undertaking to fully cooperate with the SEC in all proceedings relating to or arising from the matters in the order.

In March, the SEC announced settled charges against a Los-Angeles broker dealer for violating the Customer Protection Rule, which requires that broker-dealers safeguard the cash and securities of customers, by illegally placing more than $25 million of customers' securities at risk to fund its own operations.[65] Specifically, the broker-dealer on multiple occasions moved customers' securities to its own margin account without obtaining the customers' consent. The SEC's Press Release noted that it had recently brought several cases charging violations of the Customer Protection Rule. Without admitting or denying the allegations, the broker dealer agreed to pay a penalty of $80,000.

Also in March, the SEC filed a settled action against a New York-based broker dealer and its CEO and founder for violating the net capital rule, which requires a broker-dealer to maintain sufficient liquid assets to meet all obligations to customers and counterparties and have adequate additional resources to wind down its business in an orderly manner if the firm fails financially.[66] The SEC found that for ten months, the firm repeatedly failed to maintain sufficient net capital, failed to accrue certain liabilities on its books and records, and misclassified certain assets when performing its net capital calculations. According to the SEC, the firm's CEO was involved in discussions about the firm's unaccrued legal liabilities and was aware of the misclassified assets, but he nevertheless prepared the firm's erroneous net capital calculations. As part of the settlement, he agreed to not serve as a financial and operations principal (FINOP) for three years and to pass the required licensing examination prior to resuming duties as a FINOP; the firm agreed to pay a $25,000 penalty.

And in a novel enforcement action also arising in March, the SEC filed a settled action against the New York Stock Exchange and two affiliated exchanges in connection with multiple episodes, including several disruptive market events, such as erroneously implementing a market-wide regulatory halt, negligently misrepresenting stock prices as "automated" despite extensive system issues ahead of a total shutdown of two of the exchanges, and applying price collars during unusual market volatility on August 24, 2015, without a rule in effect to permit them.[67] The SEC also, for the first time, alleged a violation of Regulation SCI, which was adopted by the Commission to strengthen the technology infrastructure and integrity of the U.S. securities markets. The SEC charged two NYSE exchanges with violating Regulation SCI's business continuity and disaster recovery requirement. Without admitting or denying the allegations, the exchanges agreed to pay a $14 million penalty to settle the charges.

D. Other Broker-Dealer Enforcement Actions

In June, the SEC settled with a Missouri-based broker-dealer, alleging that the firm generated large fees by improperly soliciting retail customers to actively trade financial products called market-linked investments, or MLIs, which are intended to be held to maturity.[68] The SEC alleged that the trading strategy, whereby the MLIs were sold before maturity and the proceeds were invested in new MLIs, generated commissions for the firm, which reduced the customers' investment returns. The order also found that certain representatives of the firm did not reasonably investigate or understand the significant costs of the MLI exchanges. The SEC also alleged that the firm's supervisors routinely approved the MLI transactions despite internal policies prohibiting short-term trading or "flipping" of the products.

Later in June, the SEC announced that it had settled with a New York-based broker-dealer for the firm's violations of its record-keeping provisions by failing to remediate an improper commission-sharing scheme in which a former supervisor received off-book payments from traders he managed.[69] The SEC also filed a litigated complaint in federal court against the former supervisor and former senior trader for their roles in the scheme. As alleged by the SEC, the former supervisor and another trader used personal checks to pay a portion of their commissions to the firm's former global co-head of equities and to another trader. The practice violated the firm's policies and procedures and resulted in conflicts of interest that were hidden from the firm's compliance department, customers, and regulators.

E. Mortgage Backed Securities Cases

The SEC appeared to be clearing out its docket of enforcement actions dating back to the mortgage crisis.

In February, the SEC announced a settlement against a large financial institution and the former head of its commercial mortgage-backed securities ("CMBS") trading desk, alleging that traders and salespeople at the firm made false and misleading statements while negotiating secondary market CMBS sales.[70] According to the SEC's order, customers of the financial institution overpaid for CMBS because they were misled about the prices at which the firm had originally purchased them, resulting in increased profits for the firm to the detriment of its customers. The order also alleged that the firm did not have in place adequate compliance and surveillance procedures which were reasonably designed to prevent and detect the misconduct, and also found supervisory failures by the former head trader for failing to take appropriate corrective action. The firm and trader, without admitting or denying the allegations, agreed to respective penalties of $750,000 and $165,000. The firm also agreed to repay $3.7 million to customers, which included $1.48 million ordered as disgorgement, and the trader agreed to serve a one-year suspension from the securities industry.

Similarly, in mid-June, a large New York-based wealth management firm paid $15 million to settle SEC charges that its traders and salespersons misled customers into overpaying for residential mortgage backed securities (RMBS) by deceiving them about the price that the firm paid to acquire the securities.[71] The SEC also alleged that the firm's RMBS traders and salespersons illegally profited from excessive, undisclosed commissions, which in some instances were more than twice the amount that customers should have paid. According to the SEC, the firm failed to have compliance and surveillance procedures in place that were reasonably designed to prevent and detect the misconduct.

V. Insider Trading

A. Classical Insider Trading And Misappropriation Cases

In January, a former corporate insider and a former professional in the brokerage industry agreed to settle allegations that they traded on the stock of a construction company prior to the public announcement of the company's acquisition.[72] The insider purportedly tipped his friend, who was then a registered broker-dealer, about the impending transaction in return for assistance in obtaining a new job with his friend's employer following the merger. According to the SEC, the broker-dealer traded on that information for a profit exceeding $48,000. Without admitting or denying the SEC's findings, both individuals consented to pay monetary penalties, and the trader agreed to disgorge his ill-gotten gains.

The following month, the SEC sued a pharmaceutical company employee who allegedly traded in the stock of an acquisition target despite an explicit warning not to do so.[73] According to the SEC, the defendant bought stock in the other company a mere 14 minutes after receiving an e-mail regarding the acquisition. Without admitting or denying the SEC's allegations, the employee agreed to disgorgement of $2,287 and a $6,681 penalty.

In February, the SEC charged the former CEO and a former officer of a medical products company with trading on information regarding a merger involving one of their company's largest customers.[74] Without admitting or denying the allegations, the two executives agreed to disgorge a total of about $180,000 in trading proceeds and to pay matching penalties.

In March, the SEC charged a former communications specialist at a supply chain services company with garnering more than $38,000 in illicit profits after purchasing shares in his company prior to the public announcement of its acquisition.[75] Without admitting or denying the allegations, the defendant subsequently agreed to $38,242 in disgorgement and the payment of a penalty to be determined following a subsequent motion by the SEC.[76]

That same month, the SEC filed suit against the former chief information officer of a company who sold shares of his employer prior to public revelations that that company had suffered a data breach.[77] In addition, the U.S. Attorney's Office for the Northern District of Georgia brought parallel criminal charges. Both cases are still pending. Subsequently, at the end of June, the SEC charged another employee at that same company with trading on nonpublic information that he obtained while creating a website for customers affected by the data breach.[78] The defendant agreed to a settlement requiring him to return ill-gotten gains of more than $75,000 plus interest, and a criminal case filed by the U.S. Attorney's Office for the Northern District of Georgia remains ongoing.

In April, the SEC charged a New York man with tipping his brother and father about the impending acquisition of a medical-supply company based on information that he learned from his friend, the CEO of the company being acquired.[79] The SEC alleged that the father and brother garnered profits of about $145,000 based on their unlawful trading, and—without admitting or denying the SEC's allegations—the tipper agreed to pay a $290,000 penalty. The SEC's investigation remains ongoing.

Also in April, the SEC and the U.S. Attorney's Office for the District of Massachusetts filed parallel civil and criminal charges against a man accused of trading on a company's stock based on information gleaned from an unidentified insider.[80] The man purportedly purchased shares using his retirement savings in advance of eight quarterly earnings announcements over a two-year period, reaping over $900,000 in illicit profits. The SEC's complaint also names the man's wife as a relief defendant, and the matter remains ongoing.

Finally, in May, the SEC charged two men with reaping small profits by trading on non-public information in advance of a merger of two snack food companies based on information gained from a close personal friend at one of the merging companies.[81] Both defendants agreed to settle the lawsuit by disgorging ill-gotten gains and paying penalties.

B. Misappropriation by Investment Professionals and Other Advisors

At the end of May, the SEC charged a vice president at an investment bank with repeatedly using confidential knowledge to trade in advance of deals on which his employer advised.[82] The defendant allegedly used client information to trade in the securities of 12 different companies via a brokerage account held in the name of a friend living in South Korea, evading his employer's rules that he pre-clear any trades and use an approved brokerage firm. The trader purportedly garnered approximately $140,000 in illicit profits, and the U.S. Attorney's Office for the Southern District of New York filed a parallel criminal case. Both matters are still being litigated.

In June, the SEC sued a Canadian accountant for trading on information misappropriated from his client, a member of an oil and gas company's board of directors.[83] Based on this relationship, the defendant gained knowledge of an impending merger involving the company. Without admitting or denying the SEC's allegations, he agreed to be barred from acting as an officer or director of a public company, and to pay disgorgement and civil penalties of $220,500 each. The defendant also consented to an SEC order suspending him from appearing or practicing before the Commission as an accountant.

Finally, that same month, the SEC charged a credit ratings agency employee and the two friends he tipped about a client's nonpublic intention to acquire another company.[84] According to the SEC, the tipper learned the confidential information when the client reached out to the agency to assess the impact of the merger on the company's credit rating. Based on the information they received, the friends allegedly netted profits of $192,000 and $107,000, respectively. In addition, the U.S. Attorney's Office for the Southern District of New York filed a parallel criminal case against all three individuals..

C. Other Trading Cases And Developments

In February, the Third Circuit Court of Appeals issued a decision in *United States v. Metro* reversing the district court's sentencing calculation following the appellant's conviction on insider trading charges.[85] The appellant, Steven Metro, was a managing clerk at a New York City law firm, and over the course of five years, he disclosed material nonpublic information to a close friend, Frank Tamayo, concerning 13 different corporate transactions. Tamayo then transmitted that information to a third-party broker, who placed trades on behalf of Tamayo, himself, and other clients, yielding illicit profits of approximately $5.5 million. Metro pleaded guilty to one count of conspiracy and one count of securities fraud, and the district court attributed the entire $5.5 million sum to Metro in calculating the length of his sentence. Metro objected, arguing that he was unaware of the broker's existence until after he stopped tipping Tamayo.

On appeal, the Third Circuit vacated Metro's sentence after determining that the district court made insufficient factual findings to substantiate imputation of all illicit profits to Metro, holding: "When the scope of a defendant's involvement in a conspiracy is contested, a district court cannot rely solely on a defendant's guilty plea to the conspiracy charge, without additional fact-finding, to support attributing co-conspirators' gains to a defendant." The court emphasized that "when attributing to an insider-trading defendant gains realized by other individuals . . . a sentencing court should first identify the scope of conduct for which the defendant can fairly be held accountable . . . ." Such an inquiry "may lead the court to attribute to a defendant gains realized by downstream trading emanating from the defendant's tips, but, depending on the facts established at sentencing, it may not," and the court therefore found that the government erred in propounding a "strict liability" standard.

Finally, the first half of this year also saw limited activity by the SEC to freeze assets used to effectuate alleged insider trades. In January, the SEC obtained an emergency court order freezing the assets of unknown defendants in Swiss bank accounts.[86] According to the SEC, those unknown defendants were in possession of material nonpublic information regarding the impending acquisition of a biopharmaceutical company, and some of the positions taken in those accounts represented almost 100 percent of the market for those particular options. The illicit trades allegedly yielded about $5 million in profits..

VI. Municipal Securities and Public Pensions Cases

In the first half of 2018, the SEC's Public Finance Abuse Unit continued the slower pace of enforcement that began in 2017, pursuing two separate cases against municipal advisors.

In January, the SEC charged an Atlanta, Georgia-based municipal advisor and its principal with defrauding the city of Rolling Fork, Mississippi.[87] The SEC alleged that the municipal advisor had fraudulently overcharged Rolling Fork for municipal advisory services in connection with an October 2015 municipal bond offering and had failed to disclose certain related-party payments. The related-party payments consisted of an undisclosed $2500 payment made to the advisor by an employee of a municipal underwriter shortly before the advisor recommended that the city hire the underwriter's firm. The parties subsequently agreed to settle the case.[88] Without admitting or denying the allegations against them, the advisor and principal consented to the entry of judgments permanently enjoining them from violating Sections 15B(a)(5) and 15B(c)(1) of the Securities Exchange Act of 1934 and MSRB Rule G-17. The judgment also requires the defendants to pay a total of about $111,000 in disgorgement, interest, and penalties. In addition, the SEC settled its case against the municipal underwriter. Without admitting the SEC's findings, the underwriter agreed to a six-month suspension and to pay a $20,000 penalty.

And in May, the SEC brought settled administrative proceedings against another municipal advisor and its owner.[89] The SEC alleged that, by misrepresenting their municipal advisory experience and failing to disclose conflicts of interest, the advisor and owner had defrauded a South Texas school district and breached their fiduciary duties to that district. Without admitting to the allegations, the advisor and owner agreed to pay a combined total of approximately $562,000 in disgorgement, interest, and penalties..

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Gibson Dunn is one of the nation's leading law firms in representing companies and individuals who face enforcement investigations by the Securities and Exchange Commission, the Department of Justice, the Commodities Futures Trading Commission, the New York and other state attorneys general and regulators, the Public Company Accounting Oversight Board (PCAOB), the Financial Industry Regulatory Authority (FINRA), the New York Stock Exchange, and federal and state banking regulators.

Our Securities Enforcement Group offers broad and deep experience. Our partners include the former Directors of the SEC's New York and San Francisco Regional Offices, the former head of FINRA's Department of Enforcement, the former United States Attorneys for the Central and Eastern Districts of California, and former Assistant United States Attorneys from federal prosecutors' offices in New York, Los Angeles, San Francisco and Washington, D.C., including the Securities and Commodities Fraud Task Force.

Securities enforcement investigations are often one aspect of a problem facing our clients. Our securities enforcement lawyers work closely with lawyers from our Securities Regulation and Corporate Governance Group to provide expertise regarding parallel corporate governance, securities regulation, and securities trading issues, ourSecurities Litigation Group, and our White Collar Defense Group.

Gibson Dunn's lawyers are available to assist in addressing any questions you may have regarding these developments. Please contact the Gibson Dunn lawyer with whom you usually work or any of the following:

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